No. 10806.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

BARNHART-MORROW CONSOLIDATED,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REHEARING.

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TABLE OF AUTHORITIES CITED.

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To the Honorable Justices of the United States Circuit Court of Appeals for the Ninth Circuit:

The taxpayer, Barnhart-Morrow Consolidated, a corporation, respectfully presents its petition for a rehearing of the above entitled cause on the grounds hereinafter stated.

I.

The Opinion of June 22nd Erroneously Decides the Issue as to Insolvency.

On page 4 of the opinion, lines 7 to 10, the Court says that the balance sheet of petitioner "shows personal property in equipment, automobiles, etc., in value in excess of $43,789.66, title to which is *not shown to be involved in the Julian v. Schwartz receivership.*"

This statement is entirely without foundation. The balance sheet [R. 194-5] lists "oil well machinery and equipment" and "automobiles and trucks" under the heading of "capital assets", all of which were held by the *Julian v. Schwartz* receivers. The Board of Tax Appeals found [R. 195]:

> "The assets shown in the balance sheet as capital assets, except a well known as the Hartley Well (not carried as an asset after 1930), and office furniture and fixtures shown in the books after 1931 at a value of $811.50, were not in the possession of petitioner from the time of the appointment of the receiver in 1931 until the final determination of the Julian v. Schwartz litigation in 1936, but were in the possession of the receiver in that litigation and were being claimed by Schwartz and the holders of participating oil agreements as asserted in the proceeding."

On page 5 of the opinion, lines 7 to 10, the Court says:

> "Of the $43,789.66, over $15,000, supposedly owed to one Hardison, was abandoned by him in 1936; and $7,000 of this sum was expressly admitted by him to be excessive accrued salary."

On *October 28,* 1936, when the *Julian v. Schwartz* judgment became final, the balance sheet included as a liability, under the heading "Accrued Expenses—Pay Roll" [R. 104], $14,000 claimed by Guy Hardison. The Board found that it was not until *December 11,* 1936, that this claim was settled for $7,000 [R. 192-3]. The remainder of the total of "over $15,000" referred to in the opinion must be the $8500 in promissory notes held by Hardison. But, as was pointed out in oral argument, *these notes were*

not treated as liabilities after 1930 [R. 104, "Notes Payable"] and consequently do not enter into the total of $43,789.66 in liabilities under consideration.

On page 5 of the opinion, lines 10 to 14, the Court says:

> "But even if the statement of accrued liabilities be taken at face value, taxpayer's position is unsound. With its title to properties producing a net of $265,-550, established in the Superior Court in 1933, taxpayer well could have a credit greatly in excess of its accrued liabilities."

This language is a direct repudiation of the common sense approach adopted in *Artesian Water Co. v. Commissioner*, 125 Fed. (2d) 17, where the Court said:

> "As well put by the taxpayer in its brief, 'The solvency or insolvency of the petitioner, that is, its ability to pay its debts, must be determined in the actual situation in which the petitioner is found in the taxable year, and not in some false and assumed situation in which it is not found, for example, free from receivership.' "

The fact that the taxpayer had prevailed in the trial court in 1933 did not give it any standing as a borrower. The title to the disputed assets remained in question throughout the pendency of the appeal. Certainly this Court must realize that no one would lend money to a corporation whose solvency, even in the bankruptcy sense, depended upon the action of the Appellate Courts. The receipt of anything less than usurious interest could not begin to compensate the lender for the risk involved in such a loan. This would be true even if the pending action merely involved a dispute over the title to assets; but the case of

Julian v. Schwartz involved much more than that. An adverse decision on appeal would have added to the corporation's obligations the duty to account to third persons for the proceeds of past production [R. 98-99]. It seems clear to us that no one but a fool would lend money under such circumstances, and the corporation could have no credit whatsoever until the case was finally determined.

In the *Artesian Water Co.* case, the judgment in favor of the Commissioner was reversed because "all of the taxpayer's income-bearing assets were pledged . . . and in view of the receivership taxpayer's hands were just as effectively tied as if it had been in bankruptcy." Here the case for insolvency is much stronger. *All* of the taxpayer's assets were held by receivers—the income-producing assets by the receivers appointed in the *Julian v. Schwartz* case, and the remaining assets (office furniture and fixtures) by the receiver appointed in the *Morrow* case. And in addition to that, the *title* to the income-bearing assets was in dispute.

When the Board, in the opinion below, said that "no attempt was made to show inability to meet maturing debts by a reasonable use of credit" [R. 206], it was laboring under the impression that the taxpayer was required to show that the receiver (Armour), as distinguished from the corporation itself, was without credit, and that the receiver had securities carried at $219,120.50 under his control. This Court, on the authority of the *Artesian Water Co.* case, has very properly recognized that the question is as to the borrowing capacity of the corporation, not the receiver, and has impliedly conceded, as does the Commissioner himself, that the assumed securities are non-existent; but the Court has now taken an extreme position

of its own, never even suggested by counsel for the Commissioner, that the corporation could borrow on the strength of its Superior Court judgment. Even the Board's opinion recognizes that the income-bearing assets were not available as security during the pendency of the appeal [R. 206]. The truth is that during the pendency of the appeal neither the corporation nor Armour as its receiver had any borrowing capacity whatsoever.

II.

The Opinion of June 22nd Erroneously Decides the Issue as to the Deficit Credit Claimed by Taxpayer.

On page 6, lines 2-11, of the opinion, the Court says:

> "In taxpayer's computation, submitted on March 26, 1943, taxpayer suggested its right to this deficit credit; reference was made to the balance sheet of December 31, 1935, the only evidence in the record bearing upon the matter of a deficit 'as of the close of the preceding taxable year'. This shows an alleged deficit of $172,161.65, but does not purport to indicate whether it is in accumulated earnings and profits in contrast, for example, to a deficit caused by distribution of capial to shareholders or wasting of natural resource assets, or other capital depletion such as by uninsured fire or breakdown of machinery."

In our opening brief, at page 23, we cite the District Court decision in *Byron Sash & Door Co. v. U. S.*, to show that no adjustment of the balance sheet deficit was necessary because of prior capitalization of earned surplus. In that case the balance sheet deficit of $66,855.04 at the end of 1936 would have been a surplus of $63,144.96

but for a $130,000 stock dividend in 1929. In other words, in 1929 $130,000 was transferred from the earned surplus account to the capital account, and a $130,000 stock dividend was then declared. The court held that there was nevertheless a "deficit in accumulated earnings and profits" of $66,855.04 within the meaning of Section 23(c)(3) of the Revenue Act of 1936. That decision has just been affirmed by the Circuit Court of Appeals for the Sixth Circuit in *United States v. Byron Sash & Door Company,* decided June 18, 1945 and reported in Prentice-Hall, 1945 Federal Tax Service at par. 72589. The Circuit Court of Appeals said:

> "The Byron Company had a deficit in accumulated earnings and profits as of the close of the preceding taxable year and continuing for seven years before the current earnings of 1937, which in effect were impounded for the repair of its capital, and upon which the Commissioner levied the undistributed profits surtax. The trial court held that appellee was authorized by law to capitalize its accumulated earnings and profits, 'and thereby impress the assets so transferred with the same character as capital invested originally'
>
> . . . . . .
>
> "We are in accord with the foregoing determination."

If a direct transfer of surplus to the capital account for the purpose of distribution to shareholders is irrelevant to the question as to the nature of a subsequent balance sheet deficit, certainly that question is not affected by other depletions of capital charged to the earned surplus account,

such as "wasting of natural resource assets" or "uninsured fire or breakdown of machinery", referred to in the opinion in this case. The decision of this Court is therefore in direct conflict with that of the Sixth Circuit Court of Appeals in the *Byron Sash & Door Co.* case.

The record [R. 104] shows a deficit of $172,161.65 in the "surplus" account as of December 31, 1935. We know from the findings [R. 193] that at least $103,243.89 of this was a deficit caused by operating losses during the years 1931-35. In the light of the *Byron Sash & Door Co.* decision, how can the taxpayer be denied a credit against undistributed profits in at least this amount of $103,243.89? The report of that decision, which of course was not available to this Court at the time it filed the opinion in this case, should compel a reconsideration of this issue.

In our opening brief, at pages 18-20, and again in our reply brief, at page 5, we pointed out that the taxpayer was not permitted to introduce evidence as to the nature of the balance sheet deficit during the hearings under Rule 50. That rule expressly provides that:

> "Any argument under this Rule will be confined strictly to the consideration of the correct computation of the deficiency or overpayment resulting from the report already made, and no argument will be heard upon or consideration given to the issues or matters already disposed of by such report or of any new issues. This Rule is not to be regarded as affording an opportunity for rehearing or reconsideration."

When the effect of this rule was pointed out by the Board member [R. 262-263], Mr. Meitner, appearing for the taxpayer, said [R. 264] "I am not proposing any new evidence unless the Court deems it proper, if new evidence is necessary to sustain that figure. *In other words, not now.*" As soon as the proceedings had passed beyond the scope of Rule 50, the taxpayer filed a motion for rehearing, offering new evidence in the form of an analysis of the deficit account [R. 287]. This was in accordance with *the Board member's own suggestion* [R. 263]. How, then, can it be said that the Tax Court was justified in refusing to permit the introduction of this evidence? The cases cited in the opinion, at page 7, certainly do not deal with a situation such as this, in which the taxpayer has in effect been denied his day in court.

We further submit that the Court's decision is in conflict with the case of *Bell v. Commissioner* (C. C. A. 3), 139 Fed. (2d) 147, cited at pages 24-25 of our opening brief. In that case the taxpayer raised a new issue by motion for reconsideration after entry of the Tax Court's decision, and it was held that the case had to be remanded because the Tax Court had merely denied the motion for reconsideration, without making any finding as to the facts relevant to the issue thus raised. That is precisely what has occurred in this case. The very least that should be required is that the Tax Court make a finding as to whether or not there is a deficit in accumulated earnings and profits.

III.

The Opinion of June 22nd Erroneously Decides the Issue as to Deduction of Receivership Expenses.

It was stipulated [R. 83-84] that in connection with certain proposed additional assessments a hearing was held in Washington on August 13, 1937, at which hearing the net income or losses of the taxpayer were determined for the years *1930 to 1935, inclusive*. The stipulation further states that at the same hearing on August 13, 1937, certain gas revenues were determined to be income constructively received by the taxpayer "in the year 1933 and the years subsequent thereto"—that is, in 1933, 1934 and 1935 (but not in 1936, for the income for 1936 was not determined at the hearing). Finally, the stipulation declares [R. 84-85] that certain expenses were allowed as deductions from the income so constructively received, including receivership expenses, which "were allowed as deductions in and for the years in which they were definitely determined and approved by the Court in said cause of action No. 325061 wherein the said Ralph S. Armour was Receiver."

The Court, on page 8 of its opinion, says:

> "Taxpayer contends that the last sentence is a stipulation that they were only to be used as deductions for the year 1936. Such a construction makes meaningless the entire portion of the stipulation referring to the tax years 1931 to 1935, inclusive."

This represents a misunderstanding of the taxpayer's contention. The stipulation did not deal with the year 1936, but only with the years 1930-1935. There had been approvals of receivership expenses in these earlier years, and the stipulation makes it clear that the expenses so approved had been allowed as deductions for the years in which approval had been given by the Court. The taxpayer contends merely that this stipulation evidences *a recognition by the Commissioner of the rule now contended for with respect to receivership expenses approved by the Court in 1936*—that is, that they should be allowed as deductions for the year 1936, notwithstanding the fact that the expenses were incurred in prior years. Incidentally, we are informed that none of these expenses approved in 1936 had been previously approved by the Court or deducted for income tax purposes, although there were approvals and deductions of *other* receivership expenses in prior years.

This issue has been decided on a mistaken impression as to the meaning of the stipulation and the nature of the taxpayer's contention. We respectfully request a decision on the merits and submit that the applicable principles of law are those stated in our opening brief at pages 33-34. It will be observed that these principles are not denied in the brief filed by counsel for the Commissioner.

IV.

The Opinion of June 22nd Erroneously Decides the Issue as to Loss on Surrender of Well No. 16.

The Court's opinion on this issue turns upon the fact that Exhibit 57 [R. 157-158], showing the amount of the loss on surrender of Well No. 16, was offered and admitted "for the purpose of showing the method and manner in which petitioner arrived at the figure $43,151.96" and not for the purpose of showing that the taxpayer had actually sustained this loss [R. 155]. On pages 38-40 of our opening brief we carefully demonstrated, by references to the transcript, that this restriction was intended to relate only to the total of $43,151.96 and the items of depletion ($9407.29 and $8050.80) shown on the exhibit, since those particular figures involved the question of depletion, which was an issue in the case; and that no restriction was intended or understood with respect to the other figures shown on the exhibit. We respectfully ask the Court to reread these pages, 38 to 40, of our opening brief.

In any event, however, Exhibit 57 was *not* the only evidence of the loss on Well No. 16. Mr. Meitner's testimony that the figures shown on Exhibit 57 were taken by him from the books of the corporation [R. 153] was equivalent to a statement of what the books showed. While the books themselves might be the best evidence of their contents, this testimony was certainly competent and should not be disregarded. It was the document admitted as Exhibit 57 which was offered and admitted for the

limited purpose of showing the method of computation. No such limitation applied to Mr. Meitner's testimony.

For the reasons above set forth we earnestly believe that the opinion should be vacated and a rehearing granted to the taxpayer.

Respectfully submitted,

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Certificate of Counsel.

The undersigned hereby certify that in the judgment of each of them the foregoing Petition for Rehearing is well founded and that said petition is not interposed for delay.

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